COMMUNITY *the future of* BANKING

A decade ago, small banks were being gobbled up by big banks, but those days seem to be over. What are they doing now?

BY DOUG CAMPBELL

The way Roger Dick tells it, Bank of Stanly opened its doors on Jan. 26, 1984, in the tiny hamlet of Albemarle, N.C., about 40 miles east of Charlotte, on the strength of little more than the community's word that it would support a small, locally owned bank. In a town that had suddenly seen two local banks gobbled up by larger competitors, a handful of business leaders took the then-31-year-old Dick aside and asked him if he'd be interested in helping them launch a new bank.

Dick was an executive of one of the banks that was being acquired, and he quickly agreed. He drew up an offering circular himself, showed it to the North Carolina Commissioner of Banks, and got approval to start raising money. He sold $2 million in stock from the trunk of his car, insisting that no one hold more than 1 percent of the outstanding shares, a notion that many observers would consider absurd today.

Surviving for any length of time as a community bank in a rural market is no easy feat. There have been plenty of lean years, but the Bank of Stanly today endures and has even added a parent holding company to diversify its interests.

To put this accomplishment in perspective, consider that a total of 10 banks, including Stanly, were chartered in the Fifth District during 1984. Today, only the Bank of Stanly remains. The others were bought out or failed.

Says Dick, who serves as chief executive of the bank's parent company: "Occasionally, you get someone coming through saying that, for some price, you're for sale. But if I sell the bank, then I sell control in the capital in our community. I'm not going to sell."

Why Community Banks Matter

Bank of Stanly's status as sole Fifth District survivor from the Class of '84 speaks to a trend facing community banks nationwide. At the end of 1984, there were 14,351 banks with $1 billion or less in assets across the country. Entering 2004, that number was roughly halved to 7,337, according to figures kept by the Federal Deposit Insurance Corp. (Because these figures don't control for inflation, a $1 billion bank in 1984 would, in real terms, be larger than a $1 billion bank today.)

Records kept by the Fed tell a similar story in the Fifth District: Of the 310 banks that opened with new charters between 1984 and 2004, just over half — 171 of them — continue today as independent banks.

The pace of new bank charterings has followed a parallel script. In 1984, new bank openings approached 400 nationwide. Since then, there have been ups and downs, but the general trend is south.

Given those trends, it seems that community banks are losing their economic place in the U.S. financial services system, largely replaced by big banks, credit unions, and stand-alone mortgage brokers that are quickly filling the niches once occupied exclusively by homegrown banking institutions. And since community banks now hold only a small fraction of the country's total financial assets, they appear to create little systemic risk to the U.S. financial system. All this raises the following question: Do community banks matter anymore? Not surprisingly, community bankers are unequivocal about their utility, and point to the importance of having close relationships with their customers, especially when it comes to making lending decisions. At the Bank of Stanly, Dick calls it "financial services on a human scale."

Thanks to a plugged-in board of directors, community banks often are privy to personal information about clients that big banks either wouldn't know or wouldn't factor in lending decisions. "We can get more information without just relying on financial data and still make a good decision about a credit because we have a more holistic insight into clients," Dick says.

William Keeton, an economist at the Federal Reserve Bank of Kansas City, has studied the role of community banks and concludes that they remain viable and worthy of regulatory interest — though certainly not on the scale they did 20 years ago. In particular, community banks are still significant in many rural and some midsized urban settings, as well as in the crucial realm of small-business lending, Keeton says. The sort of personal lending relationships described by Bank of Stanly's Dick are crucial to understanding why community banks matter.

"It's clear to me there's going to be demand on the lending side for the kinds of services community banks provide," Keeton says. "Smaller banks have an advantage collecting information. They know the market, they have contacts in the community, and they're in a position to assess the borrower. I don't see that advantage going away."

That "advantage" is the reason why 94 percent of this nation's banks remain "community" banks, defined as having fewer than $1 billion in assets. On the flip side, community banks, as you might expect, are losing the battle for market share. Nationwide, community bank branches held 17.6 percent of all deposits in 2002, according to a Fed study, down from 29.2 percent in 1984. And in the Fifth District, the 2002 figure was even lower at 16.4 percent.

Acquisition Targets

The ability of small banks to carve out effective customer relationships has long persuaded some displaced banking executives to try their hands at opening community banks. Even amid the general decline in numbers of community banks, there have been several years when new banks sprouted in large numbers, particularly when the economy has been humming along. More than 200 banks were chartered nationwide annually between 1987 and 1989; those heights were reached again in the three years between 1999 and 2000.

Arnold Danielson, chairman of Rockville, Md.'s, Danielson Associates, an investment bank, says the availability of capital is key in driving new bank charters. Most new banks cater largely to small business owners, Danielson says. They thrive in markets that happen to be growing and are more at risk in locations where the economy is stagnant. Investing in new banks in good markets is almost always a wise move, Danielson says.

Except for one thing: A major reason many new banks have proven to be good investments is because they were later bought for some multiple of their book value. But the days of big banks buying small banks have largely come to an end. Big banks have used liberal interstate branching laws to fill in their turfs as much as they need.

So while nearly half the banks that opened in the Fifth District since 1984 have already been acquired or failed, the bulk of that activity happened among banks opening in the 1980s and early 1990s. Those banks that opened in the late 1990s don't seem to have the same exit strategy for investors that predecessors did.

"I made money on new banks, but I'm not enthusiastic right now. I don't see an exit strategy," Danielson says. "So you just don't have the typical buyers any longer."

Wood Britton, an investment banker with The Orr Group in Winston-Salem, N.C., remembers the go-go merger years of the early- and mid-1990s. In North Carolina, there were five formidable "midsized" banks — BB&T, Central Carolina Bank, Centura, Southern National, and United Carolina Bank — that frequently bid on the same deals for community banks. But four of those five were acquired by other banks, leaving only BB&T, which has transformed itself into a certified big bank with assets of more than $100 billion.

"Nowadays, if I'm going to come into North Carolina, buying a bank with $500 million in assets is not usually enough to make a dent in the marketplace," Britton says. So the number of interested potential buyers of banks of that size has diminished.

Community banks aiming to maintain their attractiveness to buyers ought to locate only in strong growth markets, Britton says. This is one reason why so many more banks are being bought in Florida in recent years than in, say, the Carolinas.

Back to Basics: With a Few Twists

The last bank to open in the Fifth District during 2004 was TriStone Community Bank of Winston-Salem. While already a crowded banking environment, Winston-Salem is a relatively strong market for growth in North Carolina. And with the 1996-opened Southern Community Bank and Trust reaching almost $1 billion in assets, TriStone organizers saw an opportunity: They would build a true "community" bank, now that Southern Community was growing beyond the benchmark $1 billion in assets.

Led by CEO Simpson O. Brown, organizers raised $16.5 million and opened TriStone on Nov. 30, one of 16 banks chartered in the Fifth District in 2004 — the highest annual total since 2000's 18. At TriStone, they are not reinventing the community banking wheel. "We are a small business bank," Brown says. "A lot of folks talk about customer service; we really put that into practice." Unusual amenities include a fireplace and wide-screen TV where clients are invited to linger.

On the more pressing matter of competing with larger rivals, TriStone has allied itself with a group of community banks through which it sells loans, keeping its own risk level down while making it seem to clients they can handle large deals.

"I think it's a very viable strategy," Brown says. "We'll do what's in the best interest of our shareholders, but we didn't build this model to sell."

Not far down the road at Bank of Stanly, CEO Dick wants the same thing for his bank. But even after a 20-year record of durability unmatched in the Fifth District, he is more cautious. Like TriStone, Bank of Stanly has diversified its offerings and set up a parent company to branch out geographically.

Yet sitting in the heart of rural North Carolina, where job losses in the textile industry have been significant, does not make Dick optimistic: "I think the hardest period to deal with is the one we're in now. To achieve that critical mass to be competitive is very complicated. I wish it didn't have to be." Even community banking is no longer simple. **RF**

Readings

Critchfield, Tim, et al. "Community Banks: Their Recent Past, Current Performance, and Future Prospects." *FDIC Banking Review*, 2004, vol. 16, nos. 3-4, pp. 1-56.

Keeton, William. "The Role of Community Banks in the U.S. Economy." Federal Reserve Bank of Kansas City *Economic Review*, Second Quarter 2003, vol. 88, no. 2, pp. 15-43.

Visit **www.richmondfed.org** for links to relevant sites.